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# Economic Letter

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*Reformers should review the loan-to-value guidelines for real estate lending, toughen them up where necessary and, most important, put the force of law behind them.*

## **Taming the Credit Cycle by Limiting High-Risk Lending**

*by Jeffery W. Gunther*

With financial turmoil apparently ebbing, all eyes are turning to reform. Nearly everyone wants to avoid a repeat of today's economic crisis and its wealth destruction, business closures, job losses, unsavory bailouts and government deficits. But what should be done? With so many likely targets, it can be difficult to know where to aim financial reform.

Several realities make successful reform appear difficult, if not impossible. First, the colossus of global financial linkages is so vast and complex that it seems incredible that policymakers could understand it, much less control it.

Second, even if financial turmoil's causes were identified and it became clear how to make the system less crisis prone, history shows that special interests would likely lobby the political process to stymie or water down reform.



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Third, even when the best possible reform is both clear and politically feasible, it might involve trade-offs, such as reduced economic dynamism and innovation, so that extreme financial volatility could be avoided only at substantial cost.

These challenges can't be denied. Contemplating them, it may be tempting to conclude we're left with two unsatisfactory alternatives—simply preparing for the next crash or imposing large-scale restrictions on the financial sector to avoid an intolerable cycle.

Meaningful reform may exist somewhere between these two extremes. In finding a middle ground, it's important to acknowledge that the immediate source of today's financial turmoil isn't new or terribly complicated. The crisis is merely the latest manifestation of an old problem—credit booms fueled by loose lending tied to rising asset prices, followed by asset-price busts that bring severe tightening of lending practices.

With this in mind, limiting high-risk lending during credit booms represents a key focus for reform. Fortunately, we know how constraint can be established for real estate lending—the loan category that dominates most credit cycles. Specifically, a simple, effective reform would involve restricting a loan's amount to no more than a specified percentage of the underlying real estate's appraised value.

A maximum loan-to-value ratio would create a cushion of borrower equity—the excess of collateral value above loan amount—available to lenders in the event of default. In addition, borrowers would face the prospect of losing their equity, making them more likely to apply only for loans they were reasonably sure to repay. By promoting such conservatism, loan-to-value regulation would guard against the speculative borrowing that leads to credit booms.

Such a prudent lending rule might go a long way toward avoiding a repeat of the current crisis and

preventing another episode in which the government and central bank are put at risk because the financial industry requires extensive support. Commonsense safeguards to limit credit based on speculative fever may seem mundane compared to flashy reform topics like credit derivatives, too-big-to-fail and executive compensation. Yet, they offer a straightforward way to bind the impulse toward unlimited credit expansion that accompanies booming asset prices.

### **Bubbles Past and Present**

In today's complex, globalized financial markets, it's easy to forget that we're working our way through an old-fashioned credit cycle, albeit a severe one. In a typical episode, financial institutions become more and more willing to lend, requiring lower and lower down payments. They're willing to take on the added risk based on the spurious notion that collateral values—most notably real estate prices—will rise indefinitely. Easy credit further stimulates collateral values in a self-reinforcing process that leads to credit and asset-price bubbles. Eventually, they pop, real estate prices fall and borrowers default.

The present troubles emerged to a large extent from the growing use of hybrid adjustable-rate mortgages with low “teaser” interest rates that would remain fixed for a few years before increasing, sometimes sharply. This type of mortgage instrument, heavily relied on by subprime borrowers, seemed likely to perform well if housing prices continued to increase.

By the time interest rates reset to a higher level, resulting in higher monthly payments, rising house prices would have built equity in the home. Borrowers could refinance their debt prior to facing higher monthly payments, or perhaps they could sell the house for a profit. Housing prices surged for a number of years, and more and more of these risky mortgages were originated, without too many apparent problems.



By historical standards, these mortgages were often a relatively high share of the purchase price, so borrowers often entered these deals with only moderate down payments, or equity. Once housing prices flattened and began to fall, these mortgages encountered severe repayment difficulties. Many borrowers defaulted, knowing they had little or negative equity and would be unable to qualify for refinancing when interest rates reset or collect any money by selling.

Hybrid adjustable-rate loans may have accounted for three-fourths of the subprime mortgages originated in 2005 and 2006. Many recent defaults have been losing bets from dashed hopes of continually rising house prices.

Once the downturn in subprime mortgages became severe, investors sought to reduce exposure to this asset class. Liquidity that had supported a wide variety of opaque investments suddenly dried up as investors, unsure of where subprime exposure actually existed, broadly withdrew funds. Financial panic magnified the current crisis—but the underlying cause was a credit boom turned to bust.

In its broad features, today's financial crisis fits the historical pattern of excesses in real estate finance followed by declining property prices and rising loan defaults. The U.S. banking crisis of the late 1980s and early 1990s followed a real estate boom and easy credit policies for commercial real estate loans. The same sort of real estate and credit cycle played out in the severe financial problems engulfing Japan throughout the 1990s and affecting several other East Asian countries in the latter part of the decade.

The lingering question is why credit booms, including this latest one, are allowed to go so far, with seemingly no mechanism to limit activity to more sustainable levels. One explanation, popular in policy and regulatory circles, stresses the difficulty of accurately identifying asset price bubbles—even after the fact, much less at the time. Efforts to pop or miti-

gate what might be a bubble could be misguided.

This view, however, is overly narrow. While the economic legitimacy of asset price surges can be difficult to assess, we can identify, based on lending practices, the degree to which the loans made during a credit boom are predicated on continued asset price increases. During the latest episode, it was duly noted that many mortgage loans made sense only if housing prices continued to rise. The question remains then—why was nothing done to limit the buildup in high-risk loans?

### **Loan-to-Value Guidelines**

Coming out of the banking crisis of the late 1980s and early 1990s, Congress was eager to curtail high-risk commercial real estate lending, a primary culprit. Reflecting this goal, early versions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) specified upper limits on the loan-to-value of real estate loans.

By the time the legislation reached its final form, however, the loan-to-value limits had disappeared. Congress merely assigned federal regulators the task of establishing standards for real estate lending. The resulting proposed regulation would have established maximum loan-to-value ratios for various types of real estate lending.

Bankers claimed the proposed regulation would have been costly, inflexible, misdirected and antigrowth. Regulators responded much like Congress did before them, reversing course and deciding against imposing the regulation on loan-to-value limits. Instead, they opted for loan-to-value guidelines that banks should follow when formulating their internal real estate lending policies. These guidelines incorporated a liberalized version of the originally proposed loan-to-value regulation, with appreciably lower equity requirements for loans.

The guidelines remain in effect today, recommending loan-to-value limits for various categories of real estate lending, such as construction or

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improved property. The guidelines, for example, call for credit enhancement in the form of mortgage insurance or extra collateral on mortgages on owner-occupied, one- to four-family residential property with a loan-to-value of 90 percent or higher at origination.

The guidelines have substantial flexibility, providing leeway for lending at loan-to-value ratios that exceed the specified maximums. However, the size of a bank's capital base limits the aggregate amount of such high loan-to-value lending.

For several reasons, relatively weak loan-to-value guidelines failed to prevent a crisis centered on home mortgage lending. First, enforcement most likely hasn't been as strict as it would have been for more binding regulation or law. Second, the 90 percent loan-to-value rule for home mortgages is fairly liberal, with historical precedent closer to 80 percent.

Third, regulators decided against applying the loan-to-value guidelines to newly originated loans that were promptly sold, with the lender retaining no formal liability for losses. This exclusion meant the guidelines didn't cover many of the home mortgages that have proven so problematic in recent years. Lenders originated the loans with the intent to quickly sell them into the securitization process, which issues bonds based on the income streams expected from loan pools.

Finally, the guidelines generally apply to insured banks and thrifts but not to other entities involved in home mortgage origination, such as nonbank subsidiaries of bank holding companies and independent mortgage companies. These lightly regulated institutions originated many of the home mortgages that have run into trouble, highlighting a critical lack of coverage by the loan-to-value guidelines.

The earlier attempt at reducing high-risk lending through loan-to-value guidelines provides a cautionary tale. The reform process began with a sense of urgency, when lawmakers, stung by

a banking crisis, prepared to set limits on the aggressiveness of real estate lending. But the loan-to-value rules were downgraded first to proposed regulation and finally to supervisory guidelines much looser than originally contemplated.

### **Making It Work**

There's no shortage of possible explanations for the loose lending practices that caused the recent crisis. We can cite regulations and government initiatives that sought to promote homeownership by easing access to mortgage credit. Or we can point a finger at deregulatory policies that some say encouraged the reckless behavior witnessed in financial markets.

Reform could get bogged down in debate over the causes of high-risk lending. Fortunately, enforcement of clear and specific rules that promote systemwide constraint on borrower leverage in real estate loans could mitigate the credit booms and busts, no matter their source.

To move forward, reformers should review the loan-to-value guidelines for real estate lending, toughen them up where necessary and, most important, put the force of law behind them—as contemplated by the early drafts of FDICIA.

Legislation specifying a loan-to-value framework would provide well-defined rules and signal strong political support. This is important to encourage strict enforcement and preclude tampering. Once positive momentum returns to real estate markets, borrowers surely will seek greater leverage, and lenders, eyeing rich returns, may want to oblige them. Under such temptations, mere guidelines could be violated or watered down. In contrast, violating the law would be a more serious matter, and changing the legislation would require Congress to act.

Effective loan-to-value legislation should apply consistently to all major types of real estate lenders, including mortgage companies, and to all or most of the real estate credit they





extend, including loans originated for sale into the securitization process. Any gaps or loopholes in the loan-to-value limits would only invite mischief.

Consistent application of a loan-to-value framework over most real estate credit shouldn't be too costly or burdensome in this digital age. It seems fair and reasonable to expect the financial system to generate the accurate and timely real estate appraisals and recording systems necessary for consistent control of loan-to-value ratios at the point of origination. This expectation can be enforced through supervisory reviews and actions, backed by legislation.

Would such legislation have prevented, or at least dampened, the recent crisis? Most likely. By some estimates, home mortgages with loan-to-value above 90 percent accounted for 35 percent to 40 percent of subprime originations in 2005 and 2006. Many of these high loan-to-value subprime mortgages didn't meet the guidelines' requirement for mortgage insurance or extra collateral. The more stringent 80 percent criterion may have been violated an astounding 60 percent of the time.

Loan-to-value reform would complement policy actions already taken in mortgage regulation. A recent amendment to Regulation Z, or Truth in Lending, will prohibit lenders from extending certain types of home mortgage loans without due consideration of borrowers' ability to repay based on income and other assets. While primarily a consumer protection issue, this amendment may also help prevent another systemic buildup of high-risk mortgages.

The Regulation Z amendment was a positive step, but an appropriately conservative loan-to-value framework would do even more to promote safe and sound mortgage lending. In addition, the framework would offer greater protection against excessive risk-taking in real estate lending generally, without being limited to just certain types of home mortgage loans.

## Room for Rules

We can get some idea of the benefits of moving from guidelines to more tightly enforced rules through a brief review of another regulatory effort to constrain or otherwise manage high-risk lending practices.

By late 2006, rising commercial real estate (CRE) exposures across the banking industry had caused substantial concern among supervisors—not surprising, given the prominent role of CRE lending in prior crises. Regulators issued guidance aimed at reinforcing sound risk management practices and appropriate levels of capital for banks with high concentrations of CRE loans on their balance sheets.

The guidance specified thresholds for determining when exposure to CRE lending warranted especially strong risk management practices. Beyond the thresholds for CRE lending in general, the guidance singled out loans for construction and land development, directing heightened supervisory attention to banks with construction loans in excess of capital.

The CRE guidance may have had some effect in cooling construction lending activity and raising awareness regarding the need for risk management, but it also has had some shortcomings. First, the initiative's introduction wasn't timely because construction loan exposures had already been increasing for many years. At the beginning of 2001, about one in 10 banks already exceeded the threshold specified six years later for construction lending. By year-end 2006, more than a fourth of commercial banks had construction loans in excess of capital.

Second, restricting construction loan exposures hasn't been a stated goal, and such lending continued to rise despite the guidance. It didn't decline relative to capital until after the real estate market had turned down—and then only slightly. At year-end 2008, more than a fourth of banks still exceeded the guidance, the same as two years earlier.

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Third, once the credit bust occurred, delinquency rates for construction loans rose most at banks the guidance identified as posing a greater risk—those with the highest concentrations of construction loans. At the end of the first quarter of this year, the average nonperforming rate on construction loans for banks exceeding the guidance was 12.71 percent, compared with 7.71 percent for active construction lenders operating within the guidance.

The high nonperformance rates for construction loans at banks flagged by the guidance suggest lending policy was especially aggressive and risky at these institutions, despite the heightened supervisory attention on them.

Moreover, souring construction loans have contributed to bank failures during the downturn. For the 50 or so commercial banks that have failed since the start of 2007, near the beginning of the downturn, the average ratio of construction loans to capital at that time was 280 percent, well above the 100 percent threshold specified by the CRE guidance. The average ratio for surviving banks was 75 percent.

Guidance may be effective in some instances, but experience with construction loans points to the need for hard-and-fast rules designed to preclude, rather than manage, the most extreme risk exposures.

### **What about Other Reforms?**

Some widely discussed reform proposals focus on requiring lenders to keep “skin in the game” and addressing the too-big-to-fail dilemma. A quick look at them—and their possible limitations—highlights the safety and soundness benefits of adding a consistently applied and rigorously enforced loan-to-value framework.

During the credit boom, mortgage companies sold loans into the securitization process, allowing them to earn fees without remaining on the hook for loan performance. With their liability limited, originators may have had

less incentive to maintain appropriately conservative lending policies.

A reform to counteract this problem could involve a requirement that mortgage originators always have skin in the game, retaining significant exposure to securitized loans. Knowing they would share in any subsequent losses, originators should be less likely to venture into high-risk lending.

While this proposal has merit, it doesn’t address high-risk banking strategies. Banks were typically at the center of the securitization process and put their own money at risk. They sometimes did their own originating and sometimes held financial stakes in the companies that sold the mortgages into the securities markets.

At times, banks retained credit risk by allowing investors to return problem mortgages from the mortgage pools backing securities. They also would sometimes support senior levels of the mortgage-backed securities by taking more subordinate positions, a commitment to bear the burden of early defaults. Moreover, banks often simply invested in the securities they or other banks had created.

Because of these practices, much of the credit risk that securitization presumably had shifted to investors actually stayed in the banking system. Since banks already have had skin in the game, the real opportunity for this type of reform may lie not with lenders but with borrowers. It would give them skin in the game.

Requiring all lenders to adhere to more prudent loan-to-value limits would lead borrowers to take higher stakes in real estate purchases and projects. The entire financial system then could operate more soundly and safely, given the cushion of borrower equity embedded in the real estate collateral supporting the loans.

Too-big-to-fail is shorthand for the potential dangers to the economy from the loss of very large and interconnected financial institutions. Massive government assistance and central bank support applied to some big, troubled



banks have bestowed upon them a degree of resilience beyond their own making, possibly tilting the competitive balance in their favor.

The extensive protections have blunted the full force that market discipline might have otherwise exerted in reshaping the competitive landscape. The existence of this safety net may also have propelled heightened risk-taking at large banks.

Where market forces are muted, it's left to lawmakers and regulators to exert the disciplining force needed to restrain excesses and promote prudent lending. Financial institutions likely to be deemed too big to fail need heightened regulatory attention and safeguards. A loan-to-value framework could prove a vital component of such an effort.

Beyond too-big-to-fail, potential for excess risk-taking arises from deposit insurance and other features of the federal safety net provided to banks of all sizes. Comprehensive loan-to-value legislation, applied consistently across all types of lenders, could play an important role in reducing these perverse incentives.

### Funding the Economy

Any restrictions on profit-generating activities are likely to be unpopular among lenders, even if the profits are only transitory. This sentiment may render lawmakers and, by extension, regulators reluctant to restrict high-risk lending, particularly when financial crises aren't in the headlines.

Almost two decades ago, bankers claimed the proposed loan-to-value regulation would crimp the supply of credit and reduce economic growth. Opponents of tougher regulation may make the same case today, but the current crisis has generated widespread agreement that a sustainable economic expansion is far superior to hyper-growth fueled by high levels of speculative credit.

Even if policymakers decide to rule out only the very loosest and most aggressive lending practices, this

restriction would be more intrusive for some financial institutions than past regulations. However, this seems a small price to pay for keeping the credit cycle below the bubble- and crisis-producing levels.

The loan-to-value framework wouldn't prevent risk-taking or displace lenders' judgment and business decisions. Rather, it would help limit leverage among borrowers and restrict high-risk real estate lending to levels commensurate with the existing capital base of credit providers. By doing so, it would help maintain the stable source of funds necessary to finance economic activity.

Real estate and credit cycles wouldn't be eliminated under the loan-to-value framework. As real estate appraisals rise in an economic upswing, so too would allowable loan amounts, implying a naturally occurring cycle. Extreme cycles, fueled by high-risk lending, are what the framework would work against.

The loan-to-value framework could be a vital component of new and stronger rules of the road for the financial industry. Policymakers might want to capitalize on how pivotal a consistently applied lending policy could be.

Loose credit and large exposures to high-risk lending need not be viewed as acceptable banking strategies. Given the government support provided to financial institutions, it would seem fair and reasonable to restrict the extreme forms of such practices, while still allowing a wide spectrum of business strategies and directions from which lenders could choose.

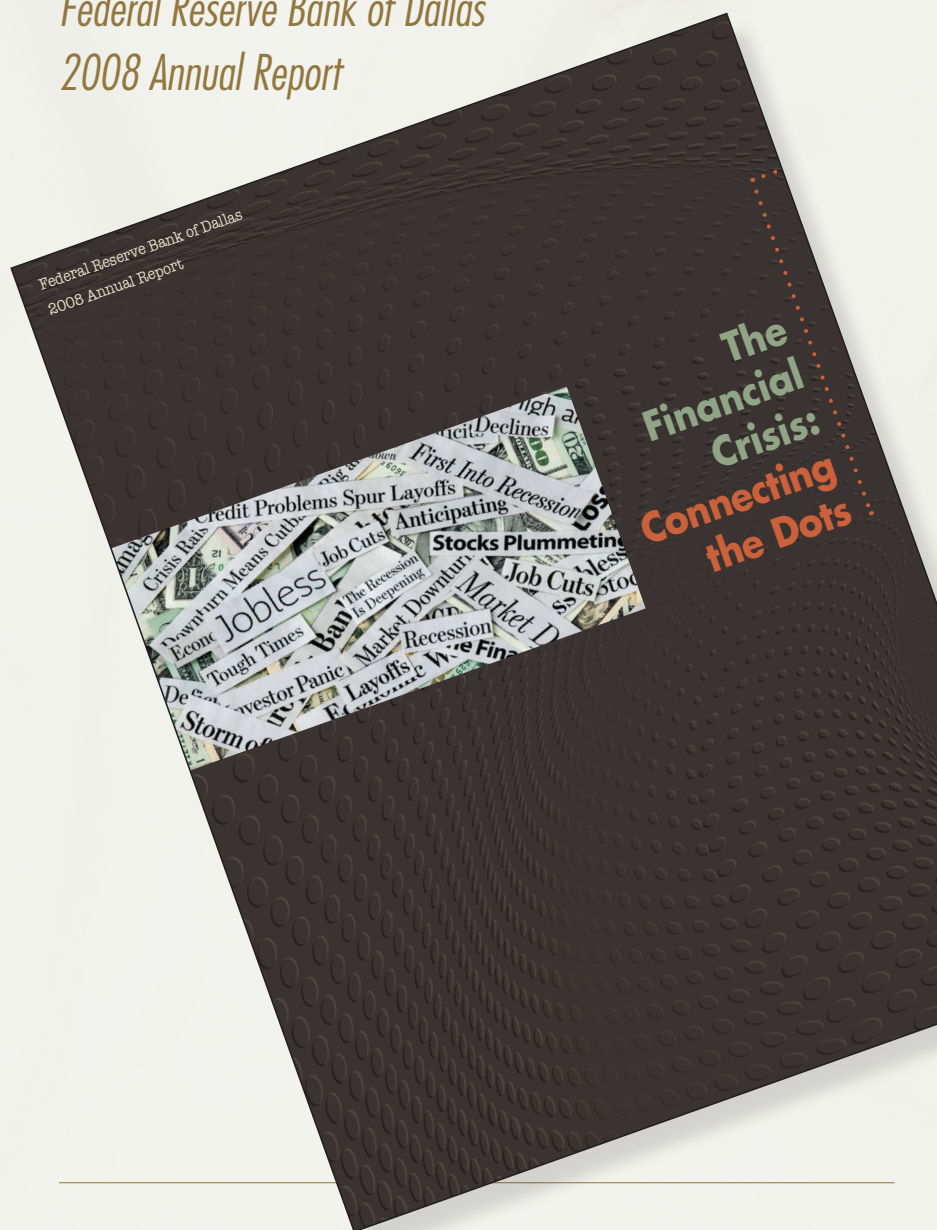
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Federal Reserve Bank of Dallas  
2008 Annual Report



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